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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

UNITED STATES OF AMERICA,

Petitioner,

vs.

CHICAGO, BURLINGTON & QUINCY RAILROAD COMPANY,

Respondent.

On Writ Of Certiorari To The United States Court Of Claims

BRIEF FOR THE CHICAGO, BURLINGTON & QUINCY RAILROAD COMPANY

OPINION BELOW.

The opinion of the Court of Claims (Pet. 1a-80a)[1] is reported at 455 F. 2d 993.

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(1) "Pet." references are to the petition for a writ of certiorari.

JURISDICTION.

The petition was filed on July 17, 1972, and certiorari was granted on October 24, 1972. (App. 113.)[2] The jurisdiction of this court rests on 28 U.S.C. 1255(1).

QUESTION PRESENTED.

Whether, in the computation of its depreciation allowances, respondent railroad was entitled to include property acquired by it prior to June 22, 1954 from the proceeds of transfers or contributions to its capital from governmental units under circumstances where respondent bears the risk of economic loss and has the obligation to replace such property.

STATUTES INVOLVED.

In addition to the statutory provisions set forth in the appendix to petitioner's brief, respondent has set forth in this appendix Sec. 113(a)(2) of the Internal Revenue Code of 1939, and the pertinent provisions of Secs. 118 and 362 of the Internal Revenue Code of 1954.

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[2] "App." references are to the separately bound record appendix.

STATEMENT.

This case involves the proper tax treatment of the cost of certain railroad property. Contrary to suggestions in petitioner's statement, this case is not concerned with the cost of highway overpass structures, or highway grading or paving. The only items which respondent claims depreciation on are portions of the cost of railroad bridge structures over highways and of crossing protection signals and automatic gates at highway-rail intersections.

The Interstate Commerce Commission prescribes uniform accounting regulations designed to show the cost of property owned by rail carriers. These are specified in several primary accounts.(3) Respondent claims a depreciation basis of $1,528,403.54 for rail bridges in Account 6 (App. 51). Respondent also claims a depreciation basis of $548,876.82 for signal protection in Account 27. This is 97% of the total amount claimed. Account 6 of the Interstate Commerce Commission Uniform Accounting Regulations provides:

> "This account shall include the cost of the substructure and superstructure of bridges, trestles and culverts which carry the tracks of the carrier over watercourses, ravines, *public* and private highways, and other railways." (49 Code of Federal Regulations, Part 1201.)

In Account 6, there is no provision for inclusion of any highway structures since it is limited to rail bridges which carry respondent's tracks over public highways.

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(3) Sec. 49 Code of Federal Regulations, Part 1200-1210.

Petitioner's assertion in their statement (Brief p. 5) that 71% of the amount claimed as the total depreciation basis by respondent represented highway overcrossings or undercrossings is inaccurate since that percentage figure relates solely to railroad bridges over public highways as shown above. No claim has ever been made by respondent for a depreciation basis on highway overcrossings or undercrossings.

These railroad facilities were located on respondent's property. They and other similar facilities were installed by respondent between 1924 and 1954. Respondent was reimbursed in part as to some of such projects from proceeds of contributions to its capital made by various governmental units. (App. 35-51, Joint Ex. 5)

The parties agreed that such facilities were property used in respondent's trade or business and were property of the type which ordinarily would be acquired through capital expenditures and were of a character normally subject to an allowance for depreciation. (Pet. 5a)

In many cases, the proposals for installation of the safety facilities originated when local communities petitioned their State Public Service Commission for installation of such facilities at rail-highway intersections (App. 95). In all the states in which respondent operates, the State Public Service Commissions have jurisdiction over (a) whether such facility must be installed by a railroad, and (b) if so, in what ratio the cost must be apportioned. (App. 94) Prior to the time reimbursement from federal highway funds was available, the cost for such installations were assessed against railroads, including respondent, at various ratios up to and sometimes ex-

ceeding 50% of the total. (App. 94) These costs were necessarily paid by respondent out of its working capital. As indicated by petitioner, one of the primary purposes of the National Industrial Recovery Act, 48 Stat. 195, 203 (1933) and the Federal Aid Highway Act of 1944, 58 Stat. 838, was to create funds to reimburse respondent and other railroads for the initial cost of certain rail-highway safety facilities. These transfers to respondent had the net effect of increasing its working capital, as well as accelerating the installation of such safety facilities throughout the country. (App. 80)

The Bureau of Public Roads allocated federal funds among the states for rail safety facilities based on a ratio of highway miles to railroad miles within each state. The State Highway Commissions allocated the funds among railroads within their state based on relative ratios of railroad mileages. (App. 91) Respondent's agreements covering the involved facilities were with the State or local governmental units. Under all such agreements respondent was obligated, at its own expense, to maintain, and replace if needed, the equipment originally installed. Respondent was required to maintain and replace the facilities directly related to railroad use, such as rail bridges and crossing signals, and the State was required to maintain and replace the facilities directly related to motor vehicle use, such as paving and embankments. (Pet. 56a)

The issue in this proceeding is the depreciation allowances on the cost of facilities directly related to railroad use. No facilities directly related to highway use are involved. Respondent claimed depreciation deductions for the year at issue in the amount of $52,789.22. The maxi-

mum amount which would be added to respondent's depreciation basis is $2,146,140. (Stipulation of Facts, pp. 5-6) The precise tax benefit in other years to respondent would vary depending on the effective tax rate and the date of installation of the facility.

The Trial Commissioner and the Court of Claims found that the involved facilities were constructed primarily for the benefit of the public, to improve safety and to expedite highway traffic flow. In addition, respondent received benefits from the facilities, including probable lower accident rates, reduced expenses of operating crossing facilities, and, in certain cases, higher train speed limits. All of this permitted respondent to function more efficiently and presumably less expensively. (Pet. 57a) The record and the findings are that the primary benefit of the transfers or contributions to respondent's capital was the better assurance of the welfare and protection of the public at large. (Pet. 7a)

2. In 1945, petitioner and respondent entered into an agreement commonly referred to as a "terms letter." (Pet. 58a) The purpose of the terms letter was to permit respondent and other railroads to change their method of accounting from retirement-replacement accounting to straight line depreciation accounting for certain rail way property. (App. 52)

Mimeo 58 was a document setting out certain suggested guidelines regarding a changeover in method of accounting, and was enclosed with the Internal Revenue Service's response to respondent's request for change in accounting method. It provided, in part, that:

> "The basis for depreciation shall be the cost of the existing depreciable property to the present taxpay-

er, determined in accordance with Sections 113 and 114(a) of the Internal Revenue Code * * *."

By letter dated April 20, 1945, respondent accepted the terms letter agreement, which did not incorporate by reference the Mimeo 58 suggested guidelines, providing, however, that "In the event that if any of the terms and conditions stated in said letter should be changed by statutory amendment, by operation of law, or otherwise" respondent would not be precluded "from the benefits of any such changes," and would be "entitled to the benefit of any such changes regardless of the acceptance herein contained." (Pet. 58a, App. 55)

The retirement method of accounting is a method recognized and accepted as proper by the Commissioner of Internal Revenue in the determination of annual depreciation deductions. Respondent continues to employ such method of depreciation accounting in regard to its investment and track accounts. Under this method of depreciation accounting, no annual depreciation deductions are taken on capital assets. Instead, a deduction for the total original cost of the asset is taken upon its ultimate retirement. The total of such deductions within a taxable year represents the depreciation allowances with respect to all items being accounted for under this system for such year. (Pet. 15a-16a)

The terms letter and the Mimeo 58 suggested guidelines related only to which of two proper methods of depreciation accounting should be applied to respondent's assets. The question now presented to this Court is whether respondent is entitled to *any* depreciation allowances for the involved assets.

3. Respondent initiated this suit in the Court of Claims, alleging, among other claims, that it had overpaid its 1955 income tax because it had not accrued depreciation allowances with respect to the cost of rail-highway safety facilities paid for out of transfers or contributions to its capital by governmental units. The Trial Commissioner and the Court of Claims held that respondent was entitled to additional depreciation deductions in 1955 in the amount of $52,789.22 on its depreciation base of $2,146,140 paid for or reimbursed by governmental units. This opinion of the Trial Commissioner and the Court of Claims that respondent was entitled to take the basis of the transferor was based on Section 113(a)(8)B of the Internal Revenue Code of 1939 which prescribed a carryover of the transferor's basis for property acquired as a contribution to capital. (Pet. 10a)

Both the Trial Commissioner and the Court of Claims held that respondent had not made a binding agreement to exclude the property from its depreciation base when it executed the terms letter agreement of 1945. (Pet. 10a)

SUMMARY OF ARGUMENT.

I. Under the 1939 Code, a taxpayer is entitled to depreciation deductions for assets if it bears the risk of economic loss and has the obligation of replacement.

A. The general rule under the 1939 Code was that a taxpayer was entitled to depreciation allowances only on its actual investment in physical assets. However, this rule is subject to a number of exceptions. These include the one here involved, that a taxpayer is entitled to carry over the basis of a transferor on a contribution to capital from a nonshareholder, when the taxpayer bears the risk of economic loss and has the obligation to replace the property. *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583 (1950).

The Court of Claims made a specific finding that respondent was obligated to replace those rail safety facilities directly related to rail use. (Pet. 7a-8a) Such a finding of fact based on an analysis of the evidence submitted at trial and reviewed by the Court of Claims must be accepted as decisive of the replacement issue, "unless clearly erroneous." *United States* v. *Yellow Cab Company,* 338 U.S. 338, 341-342 (1949).

B. The statutory basis for the exception to the general rule regarding the availability of depreciation allowances, was Section 113 of the 1939 Internal Revenue Code. Section 113(a)(2) provided for a carryover basis in the hands of the transferee if property was acquired by gift. Section 113(a)(8)(B) provided for an assump-

tion of the transferor's basis if the property was acquired from a shareholder as paid-in surplus, or if it was a nongratuitous transfer or contribution by a nonshareholder.

The *Brown Shoe* decision correctly applied the rule of statutory construction in holding that nongratuitous transfers from nonshareholders were governed by Section 113(a)(8)(B). Donative intent is not required for such transfers under that subsection.

The distinction between the receipts in *Detroit Edison* v. *Commissioner*, 319 U.S. 98 (1943) and the receipts in the *Brown Shoe* case, was a recognition that the transfers from the prospective customers in *Detroit Edison* were the price of the service rather than a nongratuitous contribution to capital.

C. Respondent had a preexisting and continuing obligation to construct rail safety facilities. Therefore, any reimbursement for such costs by nonshareholders results in and indicates an intent and purpose to enlarge respondent's working capital. A comparison of the circumstances in this case with those in the *Brown Shoe* decision demonstrates a similar manifest purpose and intent to provide facilities which would benefit the public at large.

D. The legislative history of Section 362(c) of the 1954 Internal Revenue Code clearly indicates that it was intended to overcome prospectively the effect of the *Brown Shoe* decision. It provides that nongratuitous transfers by nonshareholders shall take a zero basis for purposes of depreciation allowances. This statutory codification of the rule sought by the Commissioner of Internal Revenue in the *Brown Shoe* case cannot be retro-

actively applied to property acquired by respondent prior to the June 22, 1954 effective date. *Claridge Apartments* v. *Commissioner*, 323 U.S. 141, 164 (1944).

II. The terms letter agreement between respondent and the Commissioner of Internal Revenue, as well as the suggested guidelines contained in Mimeo 58, are clearly qualified as providing that depreciation accounting in accordance with all applicable sections of the Internal Revenue Code will be followed, and, where necessary, proper accounting adjustments shall be made. The Mimeo 58 guidelines were not included in the terms letter agreement. Therefore, the references relied on by petitioner were not a part of the actual agreement between the Commissioner and respondent.

When this Court in the *Brown Shoe* decision authoritatively determined the applicability of Section 113 to nongratuitous transfers by nonshareholders, the conditions of the terms letter agreement were changed and respondent became entitled to the benefits thereof. In addition, the suggested guidelines contained in Mimeo 58, even if applicable, were superseded by judicial determination.

All the cases cited by petitioner are inapposite because they neither considered the effect of a subsequent change in law on a terms letter agreement nor were they based on references in the suggested Mimeo 58 guidelines relied upon by petitioner in this case.

ARGUMENT.

I.

UNDER THE 1939 INTERNAL REVENUE CODE RESPONDENT IS ENTITLED TO DEPRECIATION DEDUCTIONS ON PROPERTY USED IN ITS TRADE OR BUSINESS ACQUIRED FROM THE PROCEEDS OF CONTRIBUTIONS TO RESPONDENT'S CAPITAL MADE BY GOVERNMENTAL UNITS WHEN IT HAS THE OBLIGATION TO REPLACE SUCH PROPERTY.

The railroad facilities involved in this case were used in respondent's business. Respondent had the obligation to replace them when needed; they were, in fact, contributed to it by a nonshareholder; and the result was to increase respondent's working capital. Under these circumstances, respondent had a basis under the 1939 Code equal to their cost. In the following sections each of these elements will be discussed.

A. Respondent Had The Obligation To Replace The Rail Safety Facilities Contributed By Governmental Units And Is Entitled To Depreciation Deductions.

Petitioner and respondent are in agreement that Section 23(1) of the Internal Revenue Code of 1939, as well as its successor, Section 167(a) of the 1954 Code, authorize taxpayers to take a reasonable depreciation deduction for the exhaustion, wear and tear, and obsolescence of property used in a taxpayer's trade or business. Petitioner cites several decisions in support of the general rule that the purpose of a depreciation allowance is to allow a taxpayer to deduct from his taxable income

the portion of his investment in certain capital assets which may have been used up in earning that income.(4)

It is respondent's position that under the 1939 Code there are a number of exceptions to the general rule.(5) One of these exceptions, covering the present case, is based on whether taxpayer bears the risk of economic loss or has the obligation to replace the assets, regardless of who made the investment. *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583.(6) The cases cited by petitioner are in any event clearly distinguishable from the factual situation present in this case. Indeed, the *Lazarus* case logic is more consistent with the *Brown Shoe* exception since it held that even a lessee could claim a depreciation allowance on property if the lessee, in fact, bears the risk of economic loss. 308 U.S. 252, 254.

In the *Weiss* case the taxpayer asserted a claim for depreciation allowances on property leased by him for subletting to other parties. Since the lessee in the *Weiss* case could not show an interest in the property and a present loss to him, the Court rightfully denied the taxpayer's claim for depreciation. However, the *Weiss* case also stands for the proposition that in determining the

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(4) *United States* v. *Ludey,* 274 U.S. 295, 300-301; *Helvering* v. *Lazarus & Co.,* 308 U.S. 252; *Massey Motors Inc.* v. *United States,* 364 U.S. 92; *Fribourg Nav. Co.* v. *Commissioner,* 383 U.S. 272; *Weiss* v. *Wiener,* 279 U.S. 333.

(5) Section 113(a) had 23 enumerated subsections creating such exceptions, including 113(a)(8)(B). A number of these exceptions were carried forward as part of the 1954 Code.

(6) See also *Commissioner* v. *McKay Products,* 178 F. 2d 639, 643 (C. A. 3, 1949).

availability of depreciation allowances, one must initially determine who bears the risk of economic loss. 279 U.S. 334, 336.

The *Massey Motors* case is wide of the mark since it simply held that for purposes of depreciation allowances the useful life of the asset must be related to the period for which it may reasonably be expected to be employed in taxpayer's business. 364 U.S. 92, 104.

The *Ludey* case simply stands for the principle that the depreciation charge represents the reduction during the year of the capital assets through wear and tear of the plant used. 274 U.S. 295, 300.

In the *Fribourg Navigation* case, the Commissioner disallowed depreciation deductions in the year an asset was sold for a price in excess of its adjusted basis. This Court held that the taxpayer was entitled to year-of-sale depreciation. 383 U.S. 272, 277.

In this case, all indicators are that respondent is to bear the risk of economic loss due to gradual wear or obsolescence. This is clear from the unassailed findings of fact made both by the Trial Commissioner and the Court of Claims. These conclude that respondent has the obligation to replace at its expense, equipment and facilities directly related to rail use. (Pet. 56a) As this Court held in the *Brown Shoe* case, under the 1939 Code the replacement of assets is of primary importance regardless of who made the investment.

Although petitioner cites a portion of the dissenting opinion of the court below regarding the extent of respondent's obligation under the 173 agreements admitted into evidence at the trial (Plaintiff's Exhibits 1-173),

petitioner does not directly attack the Trial Commissioner's and Court of Claims' specific fact finding on this issue. As stated by the Court of Claims:

> "Of principal importance, under every contract for constructing the facilities, plaintiff is obligated to maintain and replace the facilities at its own expense. This obligation places squarely on plaintiff the economic loss attendant to wear and tear of the property." (Pet. 7a-8a)

This finding based on the Court of Claims' analysis of the 173 detailed agreements submitted into evidence must be accepted as decisive of the replacement issue, "unless clearly erroneous." *United States* v. *Yellow Cab Company,* 338 U.S. 338, 341-342 (1949); *United States* v. *National Association of Real Estate Boards,* 339 U.S. 485, 495-496 (1950); Rule 52, Federal Rules of Civil Procedure.

In further support of this finding is the fact that in order to continue its common carrier operations, respondent, even in the absence of a specific contractual obligation of replacement, would be compelled to make needed replacements of vital links in its system, such as rail bridges over highways. It would have no practical alternative.

Petitioner further asserts that this finding is not decisive since it obligated respondent to maintain and replace only the facilities directly related to railroad use, while requiring the states to maintain and replace the highway portion of the facilities. (See discussion at page 23 of petitioner's brief.) However, this contention overlooks the fact that respondent is only claiming depreciation deductions on the facilities directly related to rail

use such as bridges and signals.[7] Respondent has never sought to claim depreciation allowances in regard to the highway portion of the facilities which would substantially exceed the relatively minor cost of the directly related rail facilities.[8]

B. Section 113 Of The 1939 Internal Revenue Code Provides The Basis For Depreciation Allowances On Respondent's Rail-Highway Safety Facilities Contributed By Non-Shareholders.

In the *Brown Shoe* case, 339 U.S. 583, this court had to consider one of a number of statutory exceptions to the general rule that a taxpayer must make an investment before being entitled to a depreciation deduction.

The exceptions were created by Section 113(a) of the 1939 Internal Revenue Code which governs the issue before the court in this case. It provides, in relevant portions:

> "Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—
>
> (2) if the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the transferor. * * *
>
> (8) Property acquired by issuance of stock or as paid-in surplus.—If the property was acquired after December 31, 1920, by a corporation—* * *

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(7) Throughout its brief, petitioner refers to the facilities involved as "highway-railroad facilities." This carries the misleading suggestion that we are dealing with concrete highway overpass structures, paving, and highway grading, which is not the case. The issues in this case actually involve "railroad facilities" located at certain highway intersections.

(8) See Joint Exhibit 5 (App. 35-51). This lists the various rail bridges and the cost with respect to each.

(B) As paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor. * * *"

The regulation pertinent to Section 113(a)(8)(B) states:

"In respect to property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from *any person* as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *" (Treasury Regulations 118, § 39.113 (a) (8)-1)

It is evident from the statute and regulation that contributions to capital may originate with nonshareholders, since, if a contribution is made by a shareholder a corporation would acquire basis under the "paid-in surplus" provision of Section 113(a)(8)(B). If it is a gift from a nonshareholder, the recipient would acquire the donor's basis under Section 113(a)(2). Therefore, unless the "contribution to capital" provision of Section 113(a)(8)(B) contemplated nongratuitous transfers by nonshareholders, it would serve no purpose in the Code, since it is a basic rule of statutory construction to give effect to all provisions.[9] This was the logical rationale of the *Brown Shoe* decision, since the transfers at issue in that case, as here, were neither gifts nor made by shareholders.

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[9] *United States* v. *Menasche*, 348 U.S. 528. Courts are powerless to rewrite tax statutes. See *Fitch Co.* v. *United States*, 323 U.S. 582 (1945); *Shakespeare Co.* v. *United States*, 419 F. 2d 839 (Ct. Cl., 1969), Cert. denied 400 U.S. 820 (1970).

Prior to the *Brown Shoe* case, this Court had occasion to analyze Section 113(a) of the 1939 Internal Revenue Code in its decision in *Detroit Edison* v. *Commissioner,* 319 U.S. 98. In the *Detroit Edison* case, nonrefundable deposits were made by potential customers in order to obtain utility services which would not otherwise be made available to them. The taxpayer utility asserted that it was entitled to depreciation deductions on investments made with the nonrefundable deposits pursuant to either Section 113(a)(2) or 113(a)(8)(B) of the 1939 Code. However, this Court denied the utility's claim to depreciation deductions, stating:

> "It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnish these funds as makers either of donations or contributions to the company. The transaction neither in form nor in substance bore such a semblance.
>
> *"The payments were to the customer the price of the service.* * * *" At pages 102-103.

It is respondent's position that the distinction as to why the present case is controlled by the *Brown Shoe* decision, rather than *Detroit Edison,* is that the payments in *Detroit Edison* were considered as income for services to be rendered, thus eliminating any basis for the recipient corporation to claim the payments as gifts or nongratuitous contributions to capital. This logical distinction was carried through as evidenced by the 1954 Internal Revenue Code Amendments. See discussion *infra* at pages 24-26.

Petitioner's argument and the dissenting opinion of the Court of Claims both err in confusing the statutory basis for respondent's claim. They stress lack of donative intent in the Federal Aid Highway Act to award any

gratuities to railroads. This would be relevant to a claim by a taxpayer based on Section 113(a)(2), providing for assumption of donor's basis in connection with gifts or gratuitous transfers.

However, the *Brown Shoe* decision was based on Section 113(a)(8)(B), the same subsection relied on by respondent, providing an exception to the general rule for nongratuitous transfers from nonshareholders. The distinction between the two subsections is the lack of any need to establish "donative intent" for claims based on Section 113(a)(8)(B). Petitioner fails to consider this vital distinction in asserting that donative intent is essential to this case.

C. Direct Effect And Purpose Of Contributions Made By Governmental Units Was To Increase Respondent's Working Capital.

In *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583, 586, at issue was the propriety of depreciation deductions on property acquired from proceeds of contributions made to the taxpayer to induce the company to locate or expand its operations in that community. The agreements between the communities and the taxpayer, in general, provided that the corporation would be granted a land site, railroad industrial tracks would be constructed, utility hookups would be provided, all city taxes would be rebated for 10 years and the City would grant $100,000 towards the cost of plant construction. The Brown Shoe Company agreed to build the plant with a minimum additional investment of $100,000 and to operate the plant for a minimum of 10 years. There was actually no obligation to replace any of the plant facilities unless required within the initial 10-year period.

In the present case, respondent is obligated to replace all equipment directly related to railroad use, thus more specifically giving rise to the accounting need to create a depreciation reserve to aid in anticipating the necessary replacement, than was present in the *Brown Shoe* case.

In *Brown Shoe,* this court, in holding that the taxpayer was entitled to depreciation deductions, stated at pp. 589-590:

> "We think the assets transferred to petitioner by the community groups represented 'contribution to capital' within the meaning of Section 113(a)(8)(B) and required no reduction in the depreciation basis of the properties acquired. The values which the taxpayer received were additions to 'capital' as that term has commonly been understood in both business and accounting practice; conformably with this usage the pertinent Treasury Regulations have consistently recognized that contributions to capital may originate with persons having no proprietary interest in the business. That this interpretation is in harmony with broad congressional policy as to depreciation deductions was emphasized by the Third Circuit when considering the similar situation presented in *Commissioner* v. *McKay Products Corp., supra,* 178 F. 2d at 643:
>
> > '* * * the assets received * * * are being used by the taxpayer in the operation of its business. They will in time wear out, and if (the taxpayer) is to continue in business, the physical plant must eventually be replaced. Looking as they do toward business continuity, the Internal Revenue Code's depreciation provisions—and especially those which provide for a substituted rather than a cost basis—would seem to envision allowance of a depreciation deduction in situations like this * * *.' "

In distinguishing the *Detroit Edison* case, this Court emphasized that the contributions were provided by communities "who neither sought nor could have anticipated any direct service of recompense whatever, the only expectation being such contributions might prove advantageous to the community at large." From these facts, the Court concluded that "the transfers manifested a definite purpose to enlarge the working capital of the company."

Much stress is placed by petitioner on distinguishing the purpose and intent of the contributions by the local communities in the *Brown Shoe* case from the contributions in this case. Actually, the important purposes, motives and intents in the *Brown Shoe* case and this case are parallel. For example, the contributions were not made for the purpose of obtaining goods, services, or privileges from the respondent. The contributions were made to benefit the public and had the effect of assuring the welfare and protection of the community at large. In *Brown Shoe,* one of the purposes of the contribution was to create employment opportunities for citizens of that community. In respondent's case the contributions were made by the federal government through local governmental units which also had the effect of increasing job opportunities during the depression era. (App. 91)

The substance of the transactions in the present case indicates more persuasively than in *Brown Shoe* an intent to enlarge respondent's working capital, since in the absence of the availability of such funds the rail safety facilities would frequently be ordered installed by State Public Service Commissions out of and in reduction of respondent's working capital. Therefore, the contributions

at issue from the Federal Highway Aid Program funded a preexisting and continuing capital obligation of respondent. That this was an intended effect of the Act is demonstrated by the method of allocating the Federal funds by the Bureau of Public Roads. The Bureau determined the allocation based on percentages of railroad miles within each state in order to benefit the working capital of the railroads in an equitable proportion. (App. 91) Although the primary purpose of the Act was to "expedite highway traffic flow" the Act also specifically contemplated contributions to railroads to reimburse them for rail safety facilities as a secondary purpose. *Under these circumstances,* the transfers to respondent and other railroads "manifested a definite purpose to enlarge their working capital."

In the *Brown Shoe* situation the recipient corporation had no preexisting capital obligation to construct new plant facilities in the local communities. Certainly the transfers to respondent manifested a purpose and had the effect of enlarging the respondent's capital which otherwise was subject to reduction for construction of rail safety facilities ordered by other governmental units.

One element of the intent can best be judged by the clear result which would flow from the contribution. As stated by the Trial Commissioner and the Court of Claims:

> "Defendant also says that the governmental payments for the facilities 'were not intended to be contributions to the capital of the railroad' but rather were 'part of the cost of the State in building its highway system'; and that the facilities are 'not re-

> lated to the production of income but rather to the safety of the local community.' No doubt, the principal purpose of the facilities was to benefit the community at large by providing improved safety at railroad highway intersections. But the fact remains that the facilities enlarged plaintiff's working capital and were used by plaintiff in its business; and though they may not produce income to the same extent as other railroad property, such as track or freight cars, plaintiff derived economic benefits from them." (Pet. 7a)

In the *Brown Shoe* case, 339 U.S. 583, there was no primary intention to enlarge the company's working capital. The local communities providing the property and funds were not directly interested in building up the capital of the Brown Shoe corporation, except to make more certain that jobs were created at their location, and the benefit to the community resulted. The welfare of the company was an incidental concern, as a means to the real public benefit purpose.

Similarly, in the present case, the public welfare was the real concern, and the benefit to respondent's working capital was secondary. But, in each case, the clear and recognizable result of the actions taken was also to increase the capital of the corporation.

As in *Brown Shoe,* the payments here involved "neither customers nor payments for service," 339 U.S. at 591. The Court found "under these circumstances" there was a definite purpose to enlarge the working capital of the company, and the circumstances were the ultimate public benefit sought by means of contributing to the company's capital.

In the present case, the structures and facilities were principally for the benefit of highway users, and not the contributors of the funds. But the contributions manifested a purpose, although secondary, to enlarge the working capital of respondent in the same sense as the contributions in the *Brown Shoe* case. The efforts of petitioner to show that in some way the present case is similar or should be controlled by the *Detroit Edison* case are untenable.

D. 1954 Internal Revenue Code Revisions Limited To Apply Prospectively Only From June 22, 1954.

Since many legal commentators believed that the effect of the *Brown Shoe* case was to overrule the *Detroit Edison* case,[10] legislative amendments were proposed which resulted in two new provisions in the Internal Revenue Code of 1954. This Court's holding in *Edwards v. Cuba Railroad*, 268 U.S. 628, was generally regarded as barring income recognition in situations similar to those present in the *Detroit Edison* case.

Therefore, in order to clarify the tax status of gifts or nongratuitous contributions to corporations, Congress added Sections 118 and 362(c) to the 1954 Internal Revenue Code. Section 118 provides that in the case of a corporation, "gross income is not to include any contribution to the capital of the taxpayer." As stated in the Senate Report:

> "This in effect places in the Code the court decisions on this subject. It deals with cases where a contribution is made to a corporation by a govern-

(10) See, The Supreme Court, 1949 Term, 64 Harvard Law Review 149-151 (1950).

mental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to receive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services." (3 U.S. Code Congressional and Administrative News, 1954, page 4648)

Section 362(c) of the 1954 Code provides that contributions to capital made by nonstockholders after June 22, 1954 would have a basis of zero in the hands of the transferee and therefore no depreciation allowances would be available with respect to these assets.

The obvious purpose of Section 362(c) was to prospectively overcome the effect of the *Brown Shoe* decision. This is indicated in the House Report on this section which provides:

"Subsection (c) has no counterpart under existing law and provides rules respecting situations similar to that which have occurred in the decision in *Brown Shoe Co.* v. *Commissioner,* (339 U.S. 583, 70 S. Ct. 820), where property was contributed to a corporation by persons other than its shareholders in their capacity as shareholders.

"In such case, paragraph (1) of subsection (c) provides that if property, other than money, is acquired by a corporation after the date of enactment of this title as a contribution to capital and is not contributed by a shareholder as such, then the basis of such property shall be zero." (3 U.S. Code Congressional and Administrative News, 1954, page 4266)

This special rule adopted by the 1954 Code is well recognized as substantially enacting the position of the

Commissioner in the *Brown Shoe* case designed to apply prospectively to the type of situation there involved. *Veterans Foundation* v. *Commissioner of Internal Revenue*, 317 F. 2d 456, 458 (C.A. 10). Volume 3A, Mertens, *Law of Federal Income Taxation*, Section 21.134.

On the other hand, under Section 118, provision for nonrecognition of income has been interpreted as not applying to the initial payments made by direct beneficiaries of the service such as the potential customers of Detroit Edison. *Teleservice Co. of Wyo. Val.* v. *CIR*, 254 F. 2d 105, (C.A. 3) cert. denied, 357 U.S. 919.

The net effect of the 1954 Code amendments was to codify the rule sought by the Commissioner, but, by its own terms the amendments were made inapplicable to the depreciation deductions claimed by respondent in this case, which were on property acquired prior to June 22, 1954.

Apparently the Commissioner believes that the subsequent vindication of his position in the *Brown Shoe* case by a statutory revision should be applied retroactively. However framed, such a position cannot obscure its fundamental weakness from a legal standpoint. It is a basic rule that statutes will not be given retroactive effect unless required by explicit language or necessary implication. *Claridge Apartments* v. *Commissioner*, 323 U.S. 141, 164 (1944). Here the explicit statutory language clearly demonstrates that it is inapplicable to property acquired prior to its effective date. Therefore, respondent's right to depreciation deductions on the rail-highway safety facilities matured exclusively under Section 113 of the 1939 Code.

As demonstrated in this brief, Section 113 and the regulations issued thereunder clearly entitle respondent to claim the depreciation deductions on those rail safety facilities it was obligated to replace and which were acquired prior to June 22, 1954. The rationale of that section is based on a recognition that the depreciation deductions should accrue to the taxpayer who bears the risk of economic loss of the facilities and has the obligation of replacement.

II.

TERMS LETTER AGREEMENT BETWEEN RESPONDENT AND COMMISSIONER IS NO BAR TO RESPONDENT'S CLAIM FOR DEPRECIATION ALLOWANCES.

By letter dated April 20, 1945, respondent accepted a "terms letter" agreement with the Commissioner of Internal Revenue, regarding a changeover in the method of depreciation accounting for certain of its roadway property. Earlier the Commissioner had prepared a set of suggested general guidelines, referred to as "Mimeo 58", relating to changeovers in accounting methods. The Mimeo 58 guidelines were not incorporated into the terms letter agreement between respondent and Commissioner, and respondent was never asked to agree to them, as conditions or otherwise. In 1961, respondent affirmed the terms letter of 1945, but again Mimeo 58 was not made a part of the agreement. The terms letter made no reference to property received as a contribution, and provided that the provisions of the Code should be followed. The conditions of the agreement were made subject to change, as needed to conform to the law.

Mimeo 58 specifically provided that "the basis for depreciation shall be the cost of the existing depreciable property to the present taxpayer, determined in accordance with Sections 113 and 114(a) of the Internal Revenue Code." (App. 58) But it also listed certain types of property which the Commissioner did not regard as having a basis, including contributions to the capital of a corporation. This was in line with the Commissioner's then interpretation of the law.

It is respondent's position that there is no basis for regarding the Mimeo 58 guidelines as being part of or limiting the terms letter agreement. But even if the Mimeo 58 guidelines were considered part of the terms letter agreement, as noted by the Court of Claims:

> "The statement 'Donated property or contributions or grants in aid of construction from any source must be excluded' was only the opinion of the Service with respect to what constituted the basis allowable under the Code and does not rise to the level of a condition upon which permission to change depreciation methods would be granted. Ultimately, the Supreme Court determined that opinion to be erroneous in the case of *Brown Shoe Co.* v. *Commissioner, supra,* and held that, pursuant to Section 113(a)(8)(B) of the 1939 Code, a taxpayer was entitled to include in its basis for depreciation certain donated property." (Pet. 9a)

The terms letter agreement is no bar to including the rail safety facilities in respondent's depreciation base for the following reasons:

1. The applicability of Section 113(a)(8)(B) to contributions to capital by governmental units was authoritatively determined by this Court in *Brown Shoe Co.* v.

Commissioner, 339 U.S. 583, and takes precedence over the opinion of the Commissioner. That the Brown Shoe decision effectuated a change in the law is evidenced by the fact that prior to 1943 the Commissioner of Internal Revenue allowed depreciation deductions to the Brown Shoe Company based on then existing interpretations of Section 113 by the Internal Revenue Service. It was only subsequent to this Court's decision in *Detroit Edison* v. *Commissioner,* 319 U.S. 98 that the Commissioner commenced to disallow depreciation deductions on contributions to capital claimed by the Brown Shoe Company.[11] Thus during the period 1943-1950, the law as interpreted by the Commissioner of Internal Revenue was that Section 113 of the 1939 Code barred claims for depreciation deductions on contributions to capital similar to those made in the *Brown Shoe* case, as well as in the instant case.

Since the terms letter agreement between respondent and Commissioner was executed in 1945, it is obvious that the *Brown Shoe Case* in 1950 effectively overruled the Commissioner's position during the period from 1943-1950 and effectuated the change in the law which would qualify respondent to then claim depreciation deductions on these rail safety facilities, in accordance with the qualified acceptance in the terms letter agreement, as well as the Mimeo 58 guidelines.

The Commissioner of Internal Revenue recognized such priority in the same documents relied upon by the peti-

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(11) See *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583, 588 where it is indicated that such was the practice of the Internal Revenue Service.

tioner. As indicated, the terms letter, which is the only agreement between the parties, specifically provided that "in the event that any of the terms and conditions stated in said letter should be changed by statutory amendment, by operation of law, or otherwise," respondent would not be precluded "from the benefits of any such changes" and would be "entitled to the benefit of any such changes regardless of the acceptance herein contained." (App. 55)

The letter of the Internal Revenue Service dated July 26, 1961, granting respondent permission to take advantage of the Retirement Straight Line Adjustment Act of 1958, 72 Stat. 1669, also provides that "it is mutually understood that complete depreciation accounting in accordance with all the applicable sections of the Internal Revenue Code and Regulations will be followed, and, where necessary, proper accounting adjustment shall be made * * *." (App. 68)

As stated by the Court of Claims:

> "The Supreme Court's decision in *Brown Shoe, supra,* distinguishing the case of *Detroit Edison, supra,* and holding that certain donated property could be added to the depreciable base, produced such a change in the conditions of the terms letter and plaintiff is entitled to the benefits thereof." (Pet. 10a)

The cases cited by petitioner regarding the irrevocability of terms letter agreements between the Commissioner and railroads regarding changeover from retirement to depreciation accounting are not applicable to the facts in the instant case because (a) they all are concerned with specific terms in a basic terms letter agreement itself and not to general references in the Mimeo 58

guidelines, and (b) they do not consider the effect of a subsequent change in law on their particular factual situations. See *Chicago, Milwaukee, St. Paul & Pacific R. Co.* v. *United States,* 404 F. 2d 960 (Ct. Cl., 1968); *Denver & Salt Lake Railway Co.* v. *Commissioner,* 24 T.C. 709; *Denver & Rio Grande Western Railroad Company* v. *Commissioner,* 32 T.C. 43, affirmed on other ground, 279 F. 2d 368 (C.A. 10).

2. Retirement accounting is a method recognized and accepted as proper by the Commissioner of Internal Revenue as a means of depreciation in lieu of the conventional ratable depreciation method. *Boston & Maine RR.* v. *Commissioner,* 206 F. 2d 617, 619 (C.A. 1, 1953). Retirement accounting involves the retention of assets on the books of a taxpayer at full value during their useful life rather than allowing annual adjustments for depreciation under the conventional ratable depreciation method.

The issue in this case is whether the respondent is entitled to any depreciation for rail safety facilities, installed from the proceeds of contributions to its capital, not whether they should be accounted for under retirement accounting or ratable depreciation.

It was recognized that "proper accounting" adjustments would be made from time to time, to comply with the law. One of these adjustments was to conform to the law as determined by the *Brown Shoe* decision in 1950. Proper procedures were followed so that respondent did not waive its right to claim this depreciation, and no relinquishment of such rights was made or intended.

It follows that if respondent is entitled to a depreciation basis under Section 113 of the 1939 Internal Revenue Code, neither the terms letter agreement nor the Mimeo 58 guidelines would bar respondent's claim. What was intended by the terms letter was to exclude property that was nondepreciable under the law. The language shows no intent to compel respondent to eliminate property which would otherwise be depreciable. By clear terms, respondent was to receive the benefit of any changes in the law, as understood at the time the agreement was signed. The Commissioner's recognition of this fact is evidenced in all the documents.

CONCLUSION.

For the reasons stated, the judgment of the Court of Claims should be affirmed.

Respectfully submitted,

Richard J. Schreiber
Robert T. Molloy
Rosslyn Building, North
1911 N. Fort Myer Drive
Arlington, Virginia 22209

Attorneys for Chicago. Burlington & Quincy Railroad Company

Robert E. Simpson
Richard T. Cubbage
Of Counsel

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APPENDIX

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.)

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * *

(2) Gifts after December 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period prior to the date of the gift as provided in subsection (b)) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information that the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner.

* * *

Internal Revenue Code of 1954
(26 U.S.C.)

Sec. 118. Contributions to the Capital of a Corporation.

(a) General rule.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Cross Reference.—For basis of property acquired by a corporation through a contribution to its capital, see section 362.

* * *

Sec. 362. Basis to Corporations.

* * *

(c) Special rule for certain contributions to capital.—

(1) Property Other than Money.—Notwithstanding subsection (a)(2), if property other than money—

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of such property shall be zero.

(2) Money.—Notwithstanding subsection (a) (2), if money—

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,
then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under

the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.